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11. (SBU) Summary: The past year has been a break point in Tajikistan's dysfunctional relationship with cotton. After losing money on cotton cultivation for years, no lender was prepared to front a single penny to finance cotton. The government responded by financing planting from the budget via domestic commercial banks, undermining the country's fragile banking system, already hard hit by falling foreign remittances. Meanwhile, the audit of the National Bank and report of an outside expert on cotton debt made clear the extent to which cotton was impoverishing the country, and cotton 'finance' simply channeled large sums of money to a well-connected elite. But with \$600 million of debt not repaid, the game was up. Senior government personnel, including, or perhaps especially, those who benefited from the old system, appear willing to make real changes in agricultural policy. What is not clear is whether this will go beyond a shift in crops to real agricultural development. The previous system was more about 'harvesting' agricultural loans than about harvesting cotton. With financing for cotton cut off, Tajik official interest in acceding to donor pressure to diversify agriculture may be motivated more by the desire to restart the flow of credit, which initially will come mainly from donors, than by genuine interest in making farming work for farmers. A key challenge for donors is ensuring funds to support agricultural diversification advance that goal and are not captured by the elite. End Summary.

Cotton Loses Money

12. (SBU) The past year has been a break point in Tajikistan's dysfunctional relationship with its main agricultural crop, cotton. Long touted as the backbone of Tajikistan's agriculture, a major employer, and hard currency earner, two outside reports made it clear that cotton has been a money-losing proposition for Tajikistan. The audit of the National Bank (reftel) could not account for a large chunk of the \$1.42 billion borrowed to finance cotton cultivation, and nearly \$600 million was not paid back. As far as can be discerned from piecing together the available records, a considerable portion of the money was diverted to other purposes by so-called "cotton investors," a dozen domestic firms that received the bulk of the loans. Where these firms could document spending on cotton cultivation, the amount was generally roughly equal to the revenue they earned from exporting cotton, with no visible margin to cover overhead or interest, much less profit.

But if investors broke even on their cotton business, their creditors and farms did not. Investors overcharged them for seed, fertilizer and other inputs they provided, while underpaying the farms for the cotton and leaving them more indebted each year. The investors were not bothered by slim or even negative margins on cotton farming, however, as another portion of the money they received from the National Bank, or with the Bank's guarantees, went to other, often unrecorded, but presumably more profitable, activities. Since a large portion of the loans were not repaid, every dollar diverted was in a sense pure profit.

¶3. (SBU) At the government's request, the World Bank brought in an expert to look at how to deal with outstanding unpaid cotton debt weighing on farms. He found that about a quarter of cotton production lost money, half broke even, and only the final quarter made a profit -- but only when cotton prices were good. With the fall in global cotton prices, along with other commodities, in 2008, every other alternative crop was more profitable than cotton. His figures clearly showed that though cotton could be profitably cultivated on a small percentage of the land, most acreage would be more usefully devoted to other purposes.

¶4. (SBU) As the cotton finance crisis unrolled over the last three years, the government retreated from claiming that cotton made a major contribution to the Tajik economy to defending it on social terms -- as a major employer to those in the countryside otherwise without occupation or income. Given that many who work in the cotton fields are not paid in cash but only with cotton stalks for winter fuel, cotton seed oil, and seed residue for animal feed, and that local governments must often coerce students and others into the fields to pick cotton, the

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social argument does not bear much weight. While cotton products for fuel, food or fodder have some value given chronic energy and food shortages, it fails to balance the costs of growing cotton.

¶5. (SBU) When unpaid loans reached critical mass in 2008, the credit was abruptly shut off. Government officials were frantic to get funds flowing again, but this proved impossible, and the government offered up budget funds for crop financing, thus ultimately sending taxpayer money into the same pockets as before. But with the budget falling seriously short, and domestic banks already pushed to the edge, that was only an interim solution. Under the circumstances, restarting commercial credit would be impossible. Only international donors could provide significant funds to finance agriculture, but they weren't willing to do so without reform. After years of foot dragging, senior government officials, led by Deputy Prime Minister Alimardon, a stalwart protector and participant in the cotton investor club, discovered new merit in donor demands to diversify agriculture.

Debt Forgiveness

¶6. (SBU) Further motivated by the global financial crisis and the concomitant drop in remittances that supported the budget, the government sought to appease donors and qualify for new loans to finance agriculture during a transition to more diversified crops. As the first step, the government agreed to a program to forgive farms' debt to cotton investors. This extended to having the National Bank of Tajikistan, domestic banks, and direct investors forgive \$661 million of the money

owed them by the cotton investors. Donors pushed hard to have cotton investors repay a portion of what they owed since not all the money they received was invested in cotton. An amount of \$154 million was settled upon, as it could be demonstrated that this sum was diverted to non-cotton activity. It remains to be seen if any is actually repaid. The National Bank is insolvent, although it paid off foreign loans to the extent possible. That left the question of what to do for domestic banks. In 2008 and 2009 the government lent money from the budget to domestic banks specifically to on-lend to the cotton investors; the banks remain responsible for repaying those loans to the government. Not surprisingly, repayment to the banks has been poor, and the banks have not been able to repay the government. If forced to repay the loans to the government, many banks would quickly become decapitalized. As part of the debt forgiveness the government is issuing treasury bills to the banks that they can hold as capital to strengthen their balance sheets. The deadlines by which the banks had to repay the government have been pushed back several times.

¶17. (SBU) A second component of reform is the "Freedom to Farm" initiative, which until now has enjoyed more lip service than implementation. It is supposed to end pressure on farmers to grow cotton. Until this year, it had only partial and sporadic impact, with most farms still reporting they were forced by local authorities to plant cotton. In 2009, while precise figures have yet to emerge, reports indicate that at least 20% of the acreage formerly under cotton cultivation was planted with other crops. A key problem is agricultural privatization was mainly cosmetic; individual farmers or family farms with solid land rights and autonomy to make decisions are the exception. Most farms are 'privatized' collective farms with a quasi-corporate/cooperative structure. Each such farm has a director who makes all decisions and is often beholden to local officials and/or cotton investors for his job. Other farm workers may "own" scattered parcels of the land as their share in the venture, but the land is farmed as a single unit under the director -- often the same person who managed the farm in Soviet days. Local authorities have forced farms to grow cotton by threatening to cut off utilities, to increase taxes and prosecutor office visits and inspections, to close local schools, and force meetings or reports to government offices.

¶18. (SBU) Most such farms are tied to a cotton investment firm, which provided inputs and/or finance, and had the right to all production. The investment firm is the real decision-maker on

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planting and other issues. By keeping the firms in their debt, the investors ensured that farms couldn't lower costs by seeking cheaper inputs from other purveyors, plant other crops, or sell output to other traders for better prices. The data gathered in a donor-funded cotton farmer survey showed that farms not tied to investors were more likely to grow crops besides cotton and to get higher prices for cotton sold. The difference in prices received by farmers from tied investors versus independent buyers ranged from 30 to 63%. In a recent meeting, officials indicated that a real "freedom to farm" might well be represented by a return to cotton since the global price had been on the rise again.

Harvesting Loans, Not Crops

¶19. (SBU) Comment: In some cases that claim may be true, but in others it may be an alibi to cover continued unwarranted pressure to favor cotton. To change how agriculture works, it will be necessary to break the relationship between the 'investors' and farms. Otherwise, even if there is a transition

to other crops, the underlying pattern that leaves farms impoverished and investors fat and powerful will remain. With cotton investors receiving such a large volume of credit, much of which was neither invested into cotton nor repaid, it is clear that the system made money by harvesting loans, not cotton.

¶10. (SBU) Comment continued: With the cotton debt resolution proceeding, major progress on land reform, new impetus on the Freedom to Farm resolution, and an actual drop of 20% or more in the land planted to cotton, the Tajik government is approaching a point where it can make a credible argument to international donors that funding agricultural finance will be necessary for agricultural reform to succeed. The full plan for this reform is expected in late January, and donors will need to be very careful about how such financing is provided and implemented. Alimardon, now the chief official in charge of agricultural reform, was directly responsible for directing \$1.4 billion into the hands of a few select investors. We need to be sure that a system to finance new crops or agriculture activities does not recreate the old pattern. A transition to new crops is likely to be full of bumps and dead ends; significant losses in the first years would not be unexpected. Without close monitoring these difficulties could provide an excuse for missing funds and non-repayment of loans. Agriculture reform is desperately needed in Tajikistan, but if agriculture finance follows the old model and donors provide funds for the elite to divert to their pockets, the money will end up wasted, further impoverishing the countryside. With the pack leaders of the old model still firmly in charge, that outcome is a real and present danger that we can not ignore as we push ahead on reform. End Comment.
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